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ABSTRACT

Perspectives on defaults occurring under the two major federal student loan programs, Guaranteed Student Loans (GSL) and National Direct Student Loans (NDSL), are presented. Attention is directed to differences in the size and mode of operation of these programs, the extent and costs of default, comparisons with other types of loans, and the outlook for future loan defaults and costs. It is noted that default rates in the larger program, GSL, are lower than in NDSL, while default rates for both programs in 1981 were slightly lower than in 1980. The default rates for private sector loans are less than those on student loans. It is suggested that the government should develop an annual measure of student loan defaults. The GSL program has made over 20 million loans worth $35 billion from 1965 through the end of 1982, while the NDSL program has made 7 million loans, totalling an estimated $8 million, from 1958 through the end of 1982. GSL default-related costs in 1981 and 1982 amounted to about 9 percent of total federal expenses. It is projected that in the next few years, default-related costs, and their share of total GSL program costs, will probably rise due to the unusually large volume of loans entering repayment and to projected declines in interest rates. (SW)

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Student Loan Default Rates in Perspective

Arthur M. Hauptman*

Considerable attention has been directed toward student loan defaults in recent years. Contradictory statements are made about the extent of the problems with loan defaults; technical language and program differences lead to misunderstandings; different rates of default are cited; and comparisons with other loan programs have not been generally available.

This paper offers perspective on defaults occurring under the two major federal student loan programs, Guaranteed Student Loans (GSL) and National Direct Student Loans (NDSL). It indicates differences in the size and mode of operation of these programs; reviews information on the extent and costs of default; offers comparison with other types of loans; and comments on the outlook for future loan defaults and costs.

This paper points out that:

- Default rates in the larger program, GSL, are lower than in NDSL. The government-reported default rates for 1981 were 12.2 percent for GSL and 15.4 percent for NDSL. When collection efforts on defaulted loans are taken into account, the "net" default rates quoted by the government for 1981 were 5.8 percent for GSL and 11.1 percent for NDSL.
- Default rates for both GSL and NDSL in 1981 were slightly lower than in 1980. The fact that default rates for student loans fell even though the unemployment rate rose indicates that enhanced default prevention and collection efforts have had a positive effect in reducing the incidence of defaults.
- Government-reported default rates for federal student loan programs are based on cumulative data compiled since the programs began, making the rates difficult to compare with annual loss rates quoted by banks for other types of loans. The government should develop an annual measure of student loan defaults so that such comparisons could be drawn regularly.
- The estimate for a "net" annual default rate for GSL in 1981 when funds collected on defaulted loans are taken into account, would be 3.8 percent. This measure is the most appropriate for comparing student loan defaults with those on other types of loans. The annual NDSL default rate, net of collections, is probably 8 to 10 percent.
- The default rates for private sector loans are less than those on student loans. However, the default rate in other federally-insured programs, such as the Small Business Administration, appears to be no better and is sometimes worse than that for student loans.
- The GSL program has made over 20 million loans worth $35 billion from 1965 through the end of 1982. The NDSL program has made 7 million loans, totalling an estimated $8 billion, from 1958 through 1982. Perhaps $10 billion of these loans from both programs are currently in repayment status, and the vast majority are being repaid on a prompt and regular basis.
- Federal costs for default-related claims on GSLs have grown much more slowly than overall program costs. GSL default-related costs in 1981 and 1982 amounted to about one-tenth of total federal expenses. In the next few years, default-related costs, and their share of total GSL program costs, will probably rise due to the unusually large volume of loans entering repayment and to projected declines in interest rates.

Comparing the Two Largest Student Loan Programs

The Guaranteed Student Loan (GSL) program was established in 1965 to encourage private lending institutions to make loans to students from low- and middle-income families. Loans are currently available to students from families with incomes of up to $30,000 and to students with family incomes above that level if need can be demonstrated. To assure the participation of banks and other lenders, the loans are guaranteed by the federal government against loss. The federal government pays the interest, currently nine percent for new participants, while the borrower remains in school and for a six-month "grace" period before repayment begins. In addition, lenders receive a "special allowance" payment from the federal government to keep their GSL revenues competitive with market rates of return.

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Since no collateral is required of GSL borrowers, a government guarantee against loss is essential to the program. The guarantee is a two-part arrangement involving both state-guarantee agencies and the federal government. First, state agencies insure the private lending institutions against loss of principal and interest if the borrower dies, is permanently disabled, is declared bankrupt, or defaults. Before a default claim can be filed, however, the borrower must be at least four months overdue on payments and the lender must have shown "due diligence" in pursuing repayment. In turn, the state agency is reinsured by the federal government, usually at 100 percent of the claim.

For a small portion of the GSL program, the federal government directly insures lenders, including a few educational institutions that act as lenders. These federally insured student loans (FISL) were authorized in the initial GLS legislation to assure loan availability for all students. With the dramatic growth of state agencies in recent years, FISL now accounts for less than five percent of all new GSL volume.

The National Direct Student Loan (NDSL) program is the other major federal student loan program. Established in 1958 as part of the National Defense Education Act, the NDSL program provides low-interest loans, originally three percent, now five percent, for needy students. Unlike GSLs, NDSLs are made by colleges and universities. The federal government provides 90 percent of the loan capital; the institutions supply the other 10 percent from their own funds. Loan repayments are funneled into a revolving fund at the educational institution which then uses the funds to make new loans.

The default experience in NDSL is an important factor in determining the pattern of new loans. As there is no federal reimbursement for NDSL defaults, every loan defaulted means fewer funds available for new loans. The more conscientious a school is in collecting old loans, the greater its revolving funds will be, and the less it will qualify for new federal funding. On the other hand, schools with high default rates receive reduced or no new federal funds. Schools can now reduce their default rate by turning over ("assigning") defaulted loans to the federal government, but they also forfeit their right to any future collections on these loans.

GSL and NDSL differences in size are illustrated below. In making these comparisons, it is important to distinguish between loan costs—expenses borne by the government that appear in the federal budget—and loan volume—the amount of money lent.

- Federal GSL expenditures for in-school interest, special allowance payments, default-related costs, and administrative expenses exceeded $3 billion in FY 1982. By contrast, federal appropriations to provide new loan capital for NDSLs were less than $200 million in 1982.
- In terms of volume, approximately three million students borrowed over $6 billion in GSLs in 1982. About one-half million students borrowed $700 million of NDSL funds, including both new appropriations and an estimated $500 million that was available through repayments of old loans.

Concerns over Student Loan Defaults

Concerns about student defaults first arose in the mid-1970s when the government released statistics indicating that the default rate for federally insured student loans (FISL) had risen to 15 percent. This incidence of defaults was attributed to the following factors:

- The first substantial group of borrowers was beginning to enter repayment status in the early 1970s, and many of them apparently thought that they had received a grant, not a loan.
- A small number of institutions had used student loans as a recruiting tool and had not given students accurate information about loan repayment; default problems were especially pronounced at these schools.
- A number of lenders had failed to develop adequate servicing procedures and, for many, it was easier to file a default claim with the government than to pursue the borrower.

To address these concerns, the Education Amendments of 1976 included provisions to improve loan collection procedures. The Amendments shifted more GSL lending to the state guarantee agencies because they have had a better record of default prevention than their counterparts in the federally insured program. Relevant provisions in the 1976 legislation included:

- Existing state agencies were encouraged to expand the volume of loans they guaranteed, and states without a guarantee agency were encouraged to create one.
- A federal payment of up to one percent of new loan volume was authorized to help state agencies cover administrative costs.
- The maximum federal reinsurance rate was raised from 80 percent to 100 percent and, for newly created state agencies, the maximum rate was assured for the first five years of operation.
- State agencies were authorized to retain up to 30 percent of the funds collected on defaulted loans in order to offset collection and administrative costs.

Since 1976, default prevention and collection procedures for federal student loans have been improved. Increased use of private collection agencies and better communication between state agencies and lenders are two reasons for this improvement. The following revisions of federal regulations have helped to prevent defaults by increasing all parties' understanding of their responsibilities:

- Lenders and schools must inform students of the nature and extent of their repayment obligations.
- Lenders must now exert greater diligence in their collection efforts.
- Institutions with NDSL default rates of 10 to 25 percent face reductions in new funds for NDSLs; institutions with default rates of over 25 percent face loss of new NDSL funding. Under rules issued this year, more than 400 schools would receive no new NDSL funding and as many as 800 schools would find their funding reduced.

Efforts have also been made to improve the collection of loans that have already been defaulted. For many years the federal government maintained no systematic record of student-loan borrowers, nor was there a close working relationship with state guarantee agencies. In recent years, there have been improvements in both recordkeeping and coordination with state agencies, although substantial problems remain. In the late 1970s, the federal government increased its own corps of collectors; the Reagan administration has relied more on contracts with private collection agencies to improve loan collection. The Debt Collection Act of 1972 now permits garnishing the wages of federal employees and retirees who are student loan defaulters. The Department of Education estimates that this new provision could apply to 50,000 federal workers who owe approximately $70 million in student loans. Other specialized efforts to collect from student loan defaulters have received considerable coverage in the news media. Recently, for instance, federal marshals in Philadelphia impounded automobiles of student defaulters until they agreed to resume payment.

How the Government Reports Student Loan Default Rates

In reporting default rates on student loans, the federal government uses a cumulative measure that consists of the dollar amount of all loans defaulted since the program began divided by the dollar amount of all loans that have ever entered repayment status.

For the GSL program (including FISL), the federal government paid approximately $1.7 billion in default claims through the end of fiscal year 1981 while about $13.8 billion in loans had entered repayment. Thus, using the Department of Education calculations, the cumulative GSL default rate in 1981 was 12.3 percent. This represents a decrease from the 12.5 percent GSL figure reported for 1980, but a slight increase over rates reported for previous years (see Figure 1). The Department of Education estimates that the GSL default rate will show some additional decline in 1982.

Figure 1: Government-Reported Statistics on Student Loan Default Rates

Fiscal Year	GSL	NDSL	"Net" of Collection Efforts GSL	NDSL
1977	10.3	16.9	Not Available	Not Available
1978	11.0	17.7	Not Available	Not Available
1979	11.5	16.0	Not Available	11.9
1980	12.5	16.1	5.9	11.9
1981	12.3	15.4	5.8	11.1

The government also reports a net default rate that takes into account its collection efforts. About $900 million in previously defaulted GSL loans had been brought back into repayment by the end of FY 1981; taking this $900 million into account produces a "net" default rate for Guaranteed Student Loans of 5.8 percent for 1981 (see Figure 1).

Estimating defaults in NDSL is difficult because, unlike GSL, there is no federal payment when a default occurs. Based on reports submitted by educational institutions, a total of approximately $890 million has been defaulted in NDSL from 1958, when the program began, through the end of FY 1981.

The NDSL default rate for 1981, as reported by the Department of Education, was 15.4 percent. This rate was derived by dividing the estimated $890 million in defaulted loans by the $5.8 billion in loans that had entered repayment status since the program began. The 15.4 percent rate is a decline from rates reported in earlier years; this rate was 16.0 percent in FY 1979 and 16.1 percent in FY 1980.

As in GSLs, the government issues an adjusted default rate for NDSLs to reflect the potential for collection. When schools and colleges turn defaulted loans over to the federal government, these loans are taken out of the institutional default rate calculation. Through the end of FY 1981, approximately $250 million in NDSL had been "assigned" to the federal government. As a result, the adjusted default rate used to determine institutional eligibility for new funding was 11.1 percent in 1981. For 1979 and 1980, the adjusted default rate for NDSL was 11.9 percent (see Figure 1).

These adjustments for collection should be interpreted cautiously, however, because they do not represent the amount actually collected by the government. In GSL, less than one-third of the dollar amount owed on defaulted loans brought back into repayment has actually been repaid. For NDSL, only a small fraction of the loans that institutions have turned over to the federal government for repayment is likely to be collected.

Comparison with Other Types of Loans

Comparing student loans with other types is one means of placing the default rate in a broader perspective. This is a difficult task because of differences in the way that default rates are calculated.

Banks generally calculate loss ratios for their loans on an annual basis. They compare their losses in one year to the amount due in loans outstanding in that year; at the year's end, irrecoverable losses are written off the books. Federally-reported default rates, as noted, are reported on a cumulative basis. Comparing annual and cumulative default rates is an "apples and oranges" procedure. Cumulative measures heavily weight the experience of previous years. Moreover, they tend to mask year-to-year changes in the incidence of default, especially in long term programs where the experience of many years can overwhelm a relatively large change in any one year. This is certainly pertinent for the GSL and NDSL programs, where it is clear that default problems were greater in the early years and that significant progress has been made in recent years.

An estimate of an "annual" default rate for GSL can be constructed as a way to compare student loan default rates with the loss rates reported by banks for other types of loans. In 1981, for example, approximately $4.6 billion of loans were in active repayment status. During 1981, the federal government paid about $260 million for default-related GSL claims and it collected about $80 million on previously defaulted loans. Based on these figures, the annual GSL default rate—net federal payments for default divided by loans in repayment—was 3.8 percent in 1981.

This "net" annual rate would seem to be a sounder basis for comparing student loan defaults with those on other types of loans. Similar data do not exist in the NDSL program; however, based on the difference in cumulative default rates reported for the two programs, the annual default rate in NDSL is likely to be approximately 8 to 10 percent.

By comparison, although mortgage delinquencies were up in 1981 because of poor economic conditions, delinquencies of 90 days or more were still less than one percent in 1981. Bank-reported losses, which take into account recoveries through foreclosures, were also less than one percent on mortgages and installment loans in 1981. The loss rates for credit card transactions in 1981 were approximately two percent.

Other federally insured loan programs provide additional bases for comparison. Annual default rates on Federal Housing Administration and Veterans Administration insured mortgages were approximately one percent. This contrasts with the federally insured loans offered through the Small Business Administration, which have default rates ranging from 5 to 10 percent annually. In some more specialized federal loan programs, the default rates are even higher.

In making these comparisons, it is necessary to assess what level of default can be considered realistic for student loans, given their special purpose and special population. Student loan

programs are intended for a population of young people, generally inexperienced in credit transactions and from families of low to moderate income. The loans are provided for educational study and, by their nature, are not secured by tangible assets which are necessary for automobile or mortgage loans. The economic climate over the last few years has not been favorable for postcollege employment and job security for young people. Further, banks and other lenders have a strong incentive to submit default claims as soon as permitted, since they receive full and immediate repayment of principal and interest on defaulted loans. Consequently, GSL and NDSL programs are not likely to have default rates as low as those quoted by banks for their loans which depend on the ability of the borrower to repay.

Reviewing GSL Default Costs

It is also useful to assess actual costs of the loan programs to the federal government, and the portion of those costs associated with loan default. This issue is applicable to the GSL program which, as already noted, incurs costs to cover federal interest payments while students are in school; a special allowance payment to lenders that fluctuates with changes in market rates of interest; and default-related expenditures.

As Figure 2 shows, federal costs to support the GSL program have grown significantly from 1977 to 1982 as a result of both increased borrowing and high interest rates, which necessitated large costs for special allowance payments to lenders. In 1981, for example, about 60 percent of GSL program costs were for special allowance payments. In that year, a one-point change in the interest on 91-day Treasury bills made a difference of approximately $200 million in GSL program costs.

Notably, default and other related payments under the GSL program account for only about one-tenth of the federal government's total costs for GSL. As Figure 2 indicates, GSL default costs grew much more slowly than overall costs in recent years.

Federal default costs in GSL, however, will probably rise substantially over the next several years as a result of the greatly increased volume of GSL borrowing between 1979 and 1982. Close to $20 billion has been lent over the past three years; as these borrowers enter repayment, there may be an upsurge in default costs, even if the default rate continues to decline. As a result, annual default costs, which totalled an estimated $300 million in fiscal year 1982, may well exceed $500 million in the next several years.

Conclusion

Both the GSL and the NDSL programs are intended to provide lower-than-market-rate loans to support postsecondary study by students from low to moderate income families. To date, over 20 million GSL loans have been made, involving a complex system of federal assistance, state agencies, and private lenders. Similarly, approximately seven million NDSL loans have been made to needy students with funds jointly provided by the federal government and institutions. These two programs have made available to students more than $40 billion over the past quarter century. The vast majority of these student borrowers are paying off their educational loans.

Loan defaults have been a problem, especially in the beginning years of these programs and among a small number of lenders. Both agencies and schools have improved their loan servicing and collection procedures in recent years. State guarantee agencies have made significant strides in implementing procedures to prevent GSL defaults and to collect on defaulted loans. Although loan defaults continue to require close attention, the problem is not as disastrous as critics have claimed.

What is the outlook for the next few years? Default costs in GSL will probably rise as the large volume of loans made in recent years comes into repayment once borrowers leave school. If predictions of level GSL volume and falling interest rates hold true, then special allowance costs will decline and default expenditures as a share of total GSL costs will increase, reversing the trend of the past several years.

The recent decline in the incidence of default for both GSLs and NDSLs—despite high unemployment—is a significant achievement. An economic recovery over the next several years may further reduce the default rates for student loans. Realistically, the default rate in student loans cannot be expected to fall to levels achieved for mortgages and other loans because of the inherent risks in making loans to young and mobile students, often inexperienced with credit transactions. There is still much room for improvement, and a reasonable goal over the next several years would be to reduce the default rates by at least one-third from current levels.

Figure 2: GSL Program Costs to the Federal Government
(dollars in millions)

	Fiscal Years					
	1977	1978	1979	1980	1981	1982
Total Federal costs for GSL	$548	$705	$999	$1,598	$2,721	$3,298
Default-related payments	$175	$239	$235	$283	$257	$310
Defaults as a % of total GSL costs	32%	34%	24%	18%	9%	9%

Note: Default-related payments include those for death, disability, and bankruptcy, as well as default. Cost figures are for federal obligations and do not reflect offsetting receipts such as collections on defaulted loans and origination fees.

Source: U.S. Budget, appendix, relevant years.